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Central Intelligence Agency

Washington D.C. 20505

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DIRECTORATE OF INTELLIGENCE

Philippine Financial Strains: Policy Decisions Ahead

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8 August 1983

Summary

Since last May, financial data gathered by the Central Bank and approaches by senior Philippine officials to Washington about possible emergency financial assistance have raised new questions about Manila's ability to service its foreign debts. The heart of the problem is a severe liquidity problem in the Central Bank at a time when the debt service burden is rising rapidly and the current account deficit shows signs of further deterioration. In light of recent developments and the outstanding short-term debt of $8-9 billion, we believe the government is more vulnerable than ever to changes in foreign bankers' perceptions of Philippine creditworthiness. At present, we believe a rescheduling or payments arrears before the end of the year is more likely than not. In any case, Manila will have to make some major decisions during the coming weeks about how to deal with both its liquidity problems and the weak balance of payments, but it may be waiting until it knows how much financial assistance it can expect from Washington.

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ON-FILE DEPT. OF TREASURY RELEASE INSTRUCTIONS APPLY

This typescript memorandum was prepared by Office of East Asian Analysis of the Directorate of Intelligence. Information available as of 29 July 1983 was used in its preparation. Comments are welcome ~~and may be directed~~ to Chief, Southeast Asia Division,

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The Current Financial State of Play

Based on reporting from all sources, Manila now appears to be in the same financial position that it has occupied for about five months: the Central Bank, because of pressures from both within the economy and pressures on the external accounts, is hard pressed to meet its daily financial commitments. Nonetheless, it manages to do so, resorting when necessary to overnight bank loans to meet its obligations. 25X1

In broader terms, the Bank is having a difficult time finding financing for a 1983 current account deficit that in our judgement will exceed $3.0 billion and medium- and long-term principal payments on the foreign debt that will reach about $1.3 billion. Revised balance-of-payments data for the first half of the year show that the current account deficit has deteriorated from 1982, when it reached a record $3.3 billion -- about 9 percent of GNP. Despite higher international prices for several commodities, exports dropped to $2.4 billion during the first two quarters, down from $2.6 billion during the same period last year. Manila has accelerated sales of gold, but net long-term loans have fallen 40 percent, further straining Central bank resources. 25X1

Source of the Bank's Problems. The Bank faces three problems that are largely responsible for its current plight and will continue to determine its financial health during the next six months. First, it suffers from illiquidity as a result of poor foreign exchange reserve management, having tied a substantial portion of its foreign exchange reserves over the last several years to credit lines as compensating balances. More recently, it has pledged much of its gold holdings against gold futures obligations. In addition, the Bank's foreign reserve department suffered personnel problems early this year, and through poor management allowed foreign deposits to fall artificially low. 25X1

On the advice of several of its major commercial creditors, the Bank is attempting to remedy these problems, but we are unable to ascertain how much progess it is making. In the meantime, the Bank commands $100-150 million in call deposits with foreign banks to manage exchange operations in the face of approximately $250 million in weekly trade turnover. To explain the decline in its foreign deposits, the Bank is claiming publicly that its foreign exchange reserve accounts are being ''consolidated,'' a deception it has used before to assuage foreign bankers. 25X1

The Bank's second problem is coping with falloffs in short-term credit lines and a deterioration in the maturity structure of its own short-term debt -- at present about $2.2 billion.* Although disbursed short-term credits grew last year, credit commitments to the Philippines as a whole fell by nearly one-third. 25X1 The Filipinos themselves have pegged the erosion in credit lines over the last 12 months at about $700 million. Prime Minister Virata and several major US banks believe that short-term credit availabilities have stabilized since May, but other

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reporting suggests the erosion continues at a slow pace. Even assuming the best, however, an increasing share of the entire government's short-term debt -- which we place at present at about two-thirds of the Philippines' total short-term debt -- must be renewed every week, as the government is having to replace three- and six-month credits with one-month, one-week, and overnight credits. [redacted] 25X1

The Bank's third, and possibly most important, problem is an inability to raise sufficient long-term capital. The government has secured several long-term credits this year, including a $300 million Central Bank syndication in February and a $100 million loan for the Development Bank of the Philippines in June. It also has nearly completed a $100 million syndication for the National Power Corporation. Even though most of the loan is to be guaranteed by the US Exim Bank, the syndication has sold very slowly. We believe that under present circumstances government agencies could not raise more than $100 million in commercial syndications during the rest of the year. The Central Bank, in particular, would have difficulty raising any money on a long-term basis, having promised creditors last February that it would not borrow again in 1983. The inability of the Bank to raise long-term capital is crucial to the current state of play, because it precludes a quiet refinancing of short-term debt as short-term credits fall off. [redacted] 25X1

The Bank simultaneously is under various pressures from the domestic economy. Three government-owned banks with outstanding obligations to both foreign commercial banks and the Central Bank are in dire financial straits themselves. These include the Development Bank of the Philippines, which is attempting to restructure its loan portfolio by converting to commercial bank status, the Philippine National Bank, which is acquiring the Development Bank's development loan portfolio, and the Land Bank of the Philippines. The financial health of the National Development Company, a holding company for joint ventures with the private sector, according to some financial analysts is also questionable, though it has moved in recent months to broaden its access to domestic funds. Six or seven large private firms with public sector equity are also in some measure of trouble, and at least three are in arrears to foreign creditors. All of these institutions constitute a potentially serious drain on Central Bank financial resources. [redacted] 25X1

The Key Actors: Perceptions and Misperceptions

Over the short-term, the perceptions of major actors in the Central Banks's liquidity crisis are of paramount importance because they will determine Manila's ability to finance daily operations. We believe the Central Bank has a cushion of about $450-500 million in outstanding credit lines with US commercial banks, but views them as a last resort. [redacted] 25X1

The Commercial Banks - For their part, most major US banks have come to the judgment that the Philippines is having serious financial problems and that a rescheduling is a possibility later this year. [redacted] 25X1 We believe most banks would gauge the odds at about even. All appreciate the nature of the financial dynamics involved, and they are concerned that the Philippines will be forced into a rescheduling not by the pressure of financing the trade deficit but by the refusal of other bankers to renew short-term credit lines. The slim margin of liquidity that the Central Bank commands makes this a factor of great concern for all involved parties, [redacted] 25X1

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The US commercial banking community may also be waiting for an indication of what Washington is willing to do to help Manila through its cash squeeze. Excellent sources report that many bankers hold the view that US security interests in the Philippines are so great that Washington almost certainly stands ready to bail Manila out. Some financial analysts even argue that this is one reason that the foreign debt has grown as rapidly as it has during the last several years, although we believe this overstates the degree to which most banks perceive Washington's role in guaranteeing Philippine sovereign risk. 25X1

There is a good chance that banks would be more willing to extend credit to the Philippines if they believed privately that a US Government bailout is in the offing, provided that they were confident that an ample volume of funds were to be made available. In our judgment, however, banks recognize that there are limits to what Washington can do and that a public bailout would be counterproductive. We believe any new commercial credits made available as an indirect result of US government action would be offset to a large degree by a withdrawal of funds by banks that perceived official bilateral assistance as a certain sign that the Philippine debt service burden has become unmanageable.

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<u>The Central Bank -</u> Manila cannot accurately predict the actions of the other players in its financial crisis. The Central Bank, for example, does not know what commercial banks will do to its credit lines during the next several months, although reliable sources report that, on the basis of current data, senior government officials are hopeful that credit availabilities will remain at their current levels. 25X1

The Central Bank has deterimined that it does not have a complete grasp of either the size and maturity structure of the foreign debt or of the flow of funds it must manage. 25X1

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The Government as a Whole. Largely because of its own disorganization, Manila probably also does not know what it can expect from Washington in the form of bilateral assistance, and this may be having an impact on the government's decisionmaking process. Virata almost certainly knows that any type of ''bridge loan,'' such as a US Treasury Exchange Stabilization Fund credit, is unavailable because ''there is nothing to bridge to,'' including advance payments on the $900 million 1985-89 military bases compensation which has yet to be approved by the US Congress. He may well anticipate Exim Bank loan guarantees, Commodity Credit Corporation credits, or advances on 1983-84 Economic Support Fund money, which is part of the current base compensation package. To ensure Central Bank liquidity, however, Virata probably thinks that at least $400-500 million would have to be made available within the next two or three months. He has told senior US officials that this amount of commercial financing is not available. He almost certainly believes that drawing down the Central Bank's credit lines in US commercial banks would send an alarm signal to the international banking community. We believe Virata is determined to avoid rescheduling the commercial debt unless default appears unavoidable. [redacted] 25X1

25X6 [redacted]

Official Creditors - The mid-July meeting of the Consultative Group, the consortium of the Philippines' aid donors chaired by the World Bank, provided an opportunity for Manila's official creditors to agree on a coordinated program of financial adjustment, while awarding Manila the $1.2 billion in aid pledges that it expected. We believe, however, that the World Bank and the International Monetary Fund are only slowly becoming aware of the concerns of key US banks and are thus to some degree uninformed about the dimensions of the government's current financial problems. Recently published IMF and World Bank data, for example, have already been dated by Central Bank financial figures recently shared with several US commercial banks. [redacted] 25X1

The Fund and the Bank are already committed to a financial program that would carry through the end of the year, although the Fund must still formally find the Philippines in compliance with the terms of the current $375 million standby loan after the mid-year review last month. We believe that the remainder of the loan, about 60 percent of the total, will be disbursed as scheduled, however, even though the Fund has reservations about Manila's failure to implement prompt adjustment measures. The World bank has already begun disbursing a $300 million Structural Adjustment Loan. [redacted] 25X1

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Decisions on the Horizon

In retrospect, we believe Manila's current options would be far less painful and free of risk had it acted decisively during 1982, when it stalemated negotiations with the IMF over a new standby loan rather than agree to the Fund's demands for adjustments in economic policy. At a time the balance of payments was deteriorating sharply, the government chose to conduct business as usual and to make adjustments in economic policy that were relatively modest. At the same time, it elected to assume the responsibility for much of the private sector's debt burden rather than allow inefficient firms to bear the burden of adjustment themselves. Manila's present dilemma is thus largely attributable to slow adjustment and unwise policy decisions. In particular, the government should have realized that its large short-term debt exposed it to undue risks in a year of international financial turbulence. In this sense, the damage to the economy of a large foreign debt burden has already been done. [redacted] 25X1

[redacted] Manila must eliminate its current account deficit in 1984 and that President Marcos stands ready to implement the necessary austerity measures. We believe it is unnecessary for Manila to adjust its external accounts this rapidly. Doing so would require a $3 billion turnaround in the merchandise trade deficit within a 12-month period, and thus cause severe disruption to an already weak Philippine economy because imports would have to be cut by nearly half. In any case, we believe that Marcos is not yet aware of the political cost of even moderate adjustment. A modest cut in imports, say of $1 billion (12 percent from 1982's level), would require further devaluations and far more budget austerity than Manila currently plans. [redacted] 25X1

Export earnings, on the other hand, may improve during the last few months of the year. Commodity prices are showing definite improvment over 1982, although in many cases they remain below the low levels of 1981. In several instances commodity prices are on the rise for reasons that portend no lasting balance-of-payments relief, however. International coconut product prices, for example, are up almost exclusively because of the 10-month drought in the Philippines, which will have an adverse impact on export volume for several years as a result of damage to trees. The drought (which ended in July) will erode export volumes for other crops, while requiring unanticipated imports of wheat and rice. As for the services deficit, increases in the London Interbank Offered Rate since early 1983 are likely to boost debt service payments by about $150 million by the end of the year, straining the current account deficit further. [redacted] 25X1

Over the next few months, commercial banks must decide whether to expand or contract their Philippine portfolios, given the realization that the country's financial position has deteriorated at an unanticipated pace during the first two quarters of 1983. The air of uncertainty surrounding the dimensions of the Philippines' problems, coupled with unconvincing government denials that it faces any difficulty at all, ensure that no new credit will be made available, and this promises to be a critical factor during the next several months. As matters now stand, we see nothing on the near term horizon that would radically change bankers' perceptions or lending behavior for the better. [redacted] 25X1

All things considered, we believe Manila is likely to select one of two possible courses of action to get it through the next year or so. As a first alternative, Manila's approaches to senior US officials during the last several months [redacted] suggests that the Philippines perceives US Government assistance as part of a ''status quo'' 25X1

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approach, which we believe it has adopted as a short-term strategy already. The approach entails slow adjustment of economic policy, combined with a ''safety net'' provided by US authorities and the IMF that Manila will use to effect a gradual and domestically palatable adjustment in its external financial position. [redacted] 25X1

Continuing this course of action runs the risk of default and largely avoids necessary policy adjustments, in our judgment. Manila's 8-percent devaluation in June, for example, was modest when compared with those taken by other financially strapped LDCs such as Indonesia (27 percent in March), and the five large industrial projects cancelled by the government were viewed by most observers as dead anyway. The simultaneous announcement that domestic oil price subsidies would be eliminated had been pledged to the IMF and World Bank in 1982. [redacted] 25X1

The government's other alternative is to take decisive action to ensure existing credit commitments and place repayment obligations on more manageable terms. [redacted] 25X1 rescheduling the short-term debt would accomplish this. Further devaluation and new austerity measures might be part of this approach and might well be insisted on by creditors as part of a rescheduling package. In any case, Manila's access to medium- and long-term capital would be appreciably enhanced by an action that removed all uncertainty about its ability to manage debt repayments -- even one that resulted from renegotiating the existing repayment schedule. [redacted] 25X1

Whatever Manila decides during the next several weeks, the debt will have to be placed on more manageable terms if the Philippine economy is to regain its growth momentum during the next few years. The short-term debt alone, at $8-9 billion, is more than twice the level necessary for trade financing and will have to be restructured eventually in any case. [redacted] 25X1

We believe that if Manila reschedules the debt, it will do so under a different label, probably calling it a ''restructuring,'' so as to minimize the negative publicity that would ensue. At present, the government is considering rescheduling the debt of the Development Bank of the Philippines, for example, one of the most vulnerable of the government's financial institutions. Manila believes that such a course of action would contain the damage that rescheduling would inflict on its international credit rating. In fact, the Bank's creditors would almost certainly invoke cross default clauses that would quickly involve the rest of the government. [redacted] 25X1

Manila will remain most vulnerable if it decides to attempt to scrape by without restructuring the debt until international credit markets settle and the current account improves. Several actions by the government during the next several months would provide evidence that Manila had committed itself to this risky strategy:

--Further draw downs in the government's credit lines in US banks.

--Further petitions to Washington for emergency bilateral assistance, even though there are limits to what Manila can expect.

--Disinformation released by the Central

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Bank designed to assuage foreign bankers about the balance of payments. This might include unusually timed press releases about export prospects for the remainder of the year.

--Insistence on the part of the Central Bank that the current exchange rate of 11 pesos per dollar be defended, even though it is still overvalued.

--An attempt by the Central Bank to quietly test financial market reaction to a second jumbo loan before the year is out. Manila is likely to find the market reaction negative. If it presses on with a new loan anyway, it will be a certain sign of a decision not to reschedule the debt.

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The Philippines: The Foreign Debt At a Glance, June 1983

Total	**$18.5 billion, excluding interbank borrowing. $22.7 billion otherwise.**
Medium- and long-term debt	$14 billion. Two-thirds owed to private banks, 40 percent at floating rates.
Term structure	Average maturity 10 years. $1.3 billion due this year, over $1.5 billion in 1984.
Interest service	$1.4 billion in 1983, over $1.5 billion next year.
Short-term debt	$4.5 billion in revolving credits and other trade financing. Commercial bank short-term debt slightly over $2 billion. Central Bank owes about $2.2 billion.
Interest service	About $700 million annually, net of Central Bank reserve asset earnings.
Central Bank liquidity	$1.6 billion in foreign exchange reserves, about two months' imports. $715 million in gold holdings. Liquidity net of short-term obligations: $173 million.
Distribution of debt	US banks: $6 billion. Largest US nine hold about $4 billion. Non-US commercial banks hold about $5 billion. US Government holds over $900 million, Japan just over $800 million, with multilateral creditors holding about $2.5 billion.
Total debt service	About $3.4 billion in 1983, or roughly 8 percent of GNP, 64 percent of merchandise exports.

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The Philippines: Balance of Payments

Million US $

	1976	1977	1978	1979	1980	1981	1982 [a]	1983 [b]
Current account	−1,101	−828	−1,172	−1,576	−2,072	−2,589	−3,347	−2,900
Merchandise trade	−1,113	−840	−1,307	−1,541	−1,939	−2,667	−2,805	−2,450
Exports, f.o.b.	2,519	3,075	3,425	4,601	5,788	5,733	4,995	5,300
Of which:								
Coconut products	537	729	812	965	759	756	647	600
Sugar	451	527	213	238	474	609	324	430
Copper concentrates	270	280	250	330	679	544	340	500
Forest products	268	261	324	484	433	383	340	400
Manufactures	573	770	1,076	1,520	1,135	1,294	1,050	1,245
Imports, f.o.b.	3,632	3,915	4,732	6,142	7,727	8,400	7,800	7,750
Oil	936	1,019	1,030	1,385	2,248	2,458	2,396	2,190
Others	2,696	2,896	3,702	4,757	5,479	5,942	5,404	5,560
Services (net)	−257	−248	−178	−390	−555	−392	−992	−900
Interest payments	−258	−302	−440	−591	−846	−1,101	−1,811	−2,200
Others	1	54	262	201	291	709	819	1,300
Transfers (net)	269	260	313	355	422	470	450	450
Capital account	1,151	963	1,082	997	1,720	2,029	2,212	1,950
Of which:								
Direct investment (net)	144	216	171	99	49	407	259	300
Medium- and long-term loans (net)	1,014	859	908	1,061	1,044	1,185	1,252	1,600
Short-term [c] loans (net)	−87	−90	83	−193	446	37	423	50
Balance	50	135	−90	−579	−352	−560	−1,135	−950

[a] Estimated.
[b] Projected.
[c] Including errors and omissions.

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